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No. 74-22

In the Supreme Court of the United States

OCTOBER TERM, 1974

IVAN ALLEN COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES

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BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (A. 124–127) is reported at 349 F. Supp. 1075. The opinion of the court of appeals (A. 131–136) is reported at 493 F. 2d 426.

JURISDICTION

The judgment of the court of appeals (A. 137–138) was entered on May 3, 1974. The petition for a writ of certiorari was filed on July 26, 1974, and was granted on December 16, 1974. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, for purposes of determining if a corporation has permitted its earnings to accumulate beyond the "reasonable needs of the business" so as to be presumptively liable for the tax on accumulated earnings, marketable securities owned by the corporation and freely available for use in its business should be taken into account at net realizable fair market value rather than at cost.

STATUTES INVOLVED

The pertinent provisions of Sections 531, 532, 533, 535, and 537 of the Internal Revenue Code of 1954, are set forth in the Appendix, *infra*, pp. 35–39.

STATEMENT

Petitioner is a corporation that sells office furniture, equipment and supplies (A. 53, 132). During its taxable years ended June 30, 1965 and 1966, petitioner's two major shareholders, Ivan Allen, Sr., and Ivan Allen, Jr., respectively owned 31.20 and 45.46 percent of petitioner's single outstanding class of common stock (A. 78, 104). For those years, petitioner reported taxable income of $341,045.82 and $629,512.19 (A. 59, 84). Petitioner's undistributed earnings as of June 30, 1965 and 1966, were respectively $2,200,-184.77 and $2,360,146.52 (A. 70, 76, 91, 111).

At the close of its taxable years ended June 30, 1965 and 1966, petitioner owned various listed and unlisted marketable securities. Their cost and fair market values were as follows (A. 55):

	Taxable year ended June 30, 1965		Taxable year ended June 30, 1966	
	Cost	Fair market value	Cost	Fair market value
40 shares Arlington Development Corp. common stock (unlisted)	$1,000	$1,000	$1,000	$1,000
300 shares C. & S. Capital Corp. common stock (listed)	1,650	788	1,650	825
$600 Commerce and Jackson County Development Corp. bond (unlisted)	600	600		
140 shares Minnesota Mining & Manufacturing Co. common stock (listed)	600	1,650		
165 shares Southern Airways common stock (listed)	3,046	8,605		
11,140 shares Xerox Corp. common stock (listed)	116,701	1,573,525		
10,090 shares Xerox Corp. common stock (listed)			102,479	2,479,617
$30,600 Xerox Corp. convertible debentures (listed)	30,625	48,424	30,625	69,768
Total	$154,222	$1,634,592	$135,754	$2,551,210

Following an audit of petitioner's income tax returns for its taxable years ended June 30, 1965 and 1966, the Commissioner of Internal Revenue determined that petitioner had permitted its undistributed earnings for each of these years to accumulate beyond the reasonable and reasonably anticipated needs of its business and that one of the purposes of the accumulation was to avoid income tax with respect to its shareholders. The Commissioner assessed accumulated earnings taxes against petitioner of $77,383.98 and $73,-131.87, for its taxable years ended June 30, 1965 and 1966 (A. 54).

Petitioner paid the tax and commenced this refund suit in the United States District Court for the Northern District of Georgia (A. 5–9). The case was decided on stipulated facts (A. 53–58). These were: that petitioner had reasonable business needs for operating capital equal to $1,198,309 and $1,455,222 for its taxable year ended June 30, 1965 and 1966; that if petitioner's marketable securities were valued at cost, its net liquid assets (current assets less current liabili-

ties) at the end of each of those taxable years, fully available for use in its business, were exactly equal to its reasonable business needs for operating capital, *viz.*, $1,198,309 and $1,455,222, respectively; that if those securities were taken into account at cost, petitioner's undistributed earnings and profits were not permitted to accumulate beyond its reasonable and reasonably anticipated business needs; that if petitioner's marketable securities were taken into account at their net fair market value[1] as of June 30, 1965 and 1966, petitioner's net liquid assets would equal $2,345,029 and $3,152,009, respectively; and that on this basis petitioner's undistributed earnings and profits were permitted to accumulate beyond its reasonable and reasonably anticipated business needs (A. 56–57)[2]

The district court held that petitioner's marketable securities could only be taken into account at cost and entered judgment for petitioner (A. 124–130). That court observed that "[c]orporate taxpayers should not be penalized for wise investments; they should be allowed to maximize their capital gains tax advantages in accordance with internal business policies and stock market conditions rather than being forced to sell securities which may have a high value on an arbitrarily selected date merely because the unrealized fair market value of the securities on that date would trigger the accumulated earnings tax" (footnote omitted) (A. 127).

[1] It was stipulated that the cost of converting petitioner's marketable securities into cash would have been a maximum of six percent of their fair market value for brokerage commissions, and a maximum of 25 percent of the net gain after commissions for capital gains taxes (A. 55).

[2] In its claim for refund (A. 26, 46), petitioner contended that substantially all of its marketable securities in companies such as Xerox Corporation and Minnesota Mining and Mfg. Co. were of corporations engaged in business related to petitioner's business of selling office furniture. However, by stipulating that its accumulations were beyond its reasonable business needs if its marketable securities had been taken into account at net realizable fair market value, petitioner abandoned this argument.

The court of appeals reversed (A. 131–136). It concluded that because petitioner's marketable securities were of such "a highly liquid character as to be readily available for business needs that might arise" (A. 135), their appreciated value should be taken into account when determining whether petitioner had accumulated earnings in excess of its reasonable business needs. In so holding, the court of appeals stated that "[t]his decision does not force the corporation to liquidate these securities at any time when a sale would be financially unwise, but only compels the corporation to comply with the proscriptions of the Code and refrain from accumulating excessive earnings and profits" (A. 135).[3]

SUMMARY OF ARGUMENT

A.

Every revenue act since the adoption of the Sixteenth Amendment in 1913 has imposed a tax upon accumulated earnings of corporations. The tax was

[3] In accordance with the agreement of the parties (A. 57–58), the court of appeals remanded the case for the additional factual determination whether one purpose for the accumulation was to avoid income tax on behalf of the shareholders (A. 136).

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enacted to foreclose the use of corporations as a means of avoiding the income tax upon dividends received by its shareholders. For without some statutory mechanism to compel the distribution of unneeded corporate earnings, a controlling shareholder would be able to postpone the income taxes on his share of the earnings in excess of corporate needs, or convert the income to capital gains through the sale of his stock, or even escape income taxation entirely by retaining his interest for ultimate transfer at his death.

The present statute is set forth in Sections 531 through 537 of the Internal Revenue Code of 1954. Section 531 imposes a tax "[i]n addition to other taxes imposed by this chapter * * * on the accumulated taxable income * * * of every corporation" that is (Section 532(a)) "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders * * *" by permitting earnings and profits to accumulate instead of being distributed. Section 533(a) provides a rebuttable presumption that a corporation which has accumulated earnings "beyond the reasonable needs of the business" did so with "the purpose to avoid the income tax with respect to shareholders * * *." The objective fact of the accumulation is "determinative" of the tax avoidance motive "unless the corporation by the preponderance of the evidence shall prove to the contrary."

This case focuses upon the extent to which a corporation's true economic condition becomes relevant in determining its liability for the tax upon "accumulated taxable income." The question presented is

whether, for purposes of determining accumulated earnings tax liability, marketable securities owned by a corporation should be taken into account at their net realizable fair market value or, as petitioner contends, at cost. Here, petitioner owned marketable securities which increased twenty-fold in value to an amount far beyond its stipulated reasonable business needs for the taxable years at issue. Because the marketable securities represented liquid assets freely available for use in petitioner's business, the Commissioner took their net realizable fair market value into account in determining whether petitioner had accumulated earnings "beyond the reasonable needs of the business" within the meaning of Section 533(a).

The decision of the court of appeals upholding the Commissioner's measure of petitioner's true economic condition properly implements the congressional purpose underlying the accumulated earnings tax. That purpose, as stated by this Court, is "to compel the company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual stockholders will become liable" for taxes on the dividends received. *Helvering* v. *Stock Yards Co.*, 318 U.S. 693, 699.

B.

1. The objective inquiry required by Section 533(a) involves an initial comparison of the corporation's "accumulated" "earnings and profits" with the "reasonable needs of the business." However, much of a corporation's accumulated earnings and profits on the liabilities side of the balance sheet is often reflected

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in a variety of fixed assets which are unavailable for distribution as dividends. A rigid mathematical comparison of "accumulated earnings and profits" with the "reasonable needs of the business" is therefore an inaccurate gauge of the assets freely available to meet the needs of the business. As a result, the courts have long held, and petitioner concedes, that the determination whether a corporation has permitted earnings and profits to accumulate beyond the reasonable needs of its business requires an examination of the extent to which its liquid assets exceed its reasonably anticipated business needs.

Once it is recognized that the application of the accumulated earnings tax turns on whether the corporation has liquid assets in excess of its reasonable business needs, it follows that the decision below correctly held that such assets must be taken into account at their net realizable value. When such liquid assets are marketable securities which are readily convertible into cash, their proper measure is their net realizable value, since it is that amount that determines the corporation's liquidity. The cost of such liquid assets bears little, if any, relevance to the current financial condition of the corporation and its capacity to pay dividends. Their cost is simply a balance sheet entry for historical purposes. Since the net realizable value of such highly liquid assets exceeded petitioner's reasonable business needs, it could not justify the accumulation of any of its taxable income for the two years at issue. Petitioner's failure to distribute that income to its shareholders triggers the accumulated earnings tax.

In urging that, for the purposes of this case, the correct measure of petitioner's marketable securities is their net realizable value, we do not contend that the unrealized appreciation of these securities is "earnings and profits" within the meaning of Section 533(a). Rather, petitioner's ownership of these securities, which are freely available for use in its business, rendered unreasonable its failure to distribute to its shareholders its earnings for the years at issue for purposes of the tax on accumulated earnings. Pursuant to Section 535(a), it is those earnings, which are included in "accumulated taxable income", upon which the tax is imposed. The fact that the unrealized appreciation of petitioner's securities is not included in earnings and profits does not foreclose its consideration in determining whether the corporation is subject to the tax on accumulated earnings.

2. The court of appeals correctly recognized that this Court's decision in *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282, 291, has essentially resolved the question presented in this case. There, the Court held that unrealized losses in the value of marketable securities owned by a corporation were "evidence to be considered" in determining whether the corporation was liable for the accumulated earnings tax. The teaching of *Nat. Grocery Co.* is fully applicable to the converse situation presented here where petitioner's liquid assets have appreciated in value. In both cases, a realistic determination of corporate liquidity requires that such assets be taken into account at their net realizable value.

Nothing in *American Trading & Production Corp. v. United States*, 362 F. Supp. 801 (D. Md.), affirmed *per curiam* on the opinion of the district court, 474 F. 2d 1341 (C.A. 4), supports petitioner's argument that its marketable securities should be taken into account at cost. To the extent that the decision in that case turned on the fact that the taxpayer's marketable securities were part of its original capital or upon the ground that the accumulated earnings tax statute did not require the conversion of such assets to cash to meet business needs, it is erroneous. However, one of the grounds of that decision was that certain securities were not marketable in the hands of its corporate owner because of restrictions imposed by the securities laws. Hence, the court totally excluded such securities from consideration because they were not in fact liquid under the peculiar circumstances of that case. On this latter ground the case is distinguishable.

3. The decision of the court of appeals does not, as petitioner argues, force a conversion of its marketable securities into cash. Such conversion could be avoided only if marketable securities were totally excluded from consideration, a position petitioner does not advance. However, even under petitioner's cost valuation rule, situations could arise where the corporation would still have to convert marketable securities into cash if it wished to avoid the imposition of the accumulated earnings tax. Thus, there is nothing inherent in taking marketable securities into account at net realizable value which requires conversion of such securities into cash. The reason for applying the net realizable value rule to marketable securities, which we urge here, is that it reflects the

utility of those assets for use in meeting the reasonable business needs of the corporation more accurately than their cost.

ARGUMENT

MARKETABLE SECURITIES OWNED BY A CORPORATION AND FREELY AVAILABLE FOR USE IN ITS BUSINESS SHOULD BE TAKEN INTO ACCOUNT AT NET REALIZABLE FAIR MARKET VALUE IN DETERMINING WHETHER THE CORPORATION HAS PERMITTED ITS EARNINGS TO ACCUMULATE BEYOND THE REASONABLE NEEDS OF THE BUSINESS

A. INTRODUCTION

Under our system of income taxation, corporate earnings are subject to tax at two different levels. First, there is a tax imposed upon the income of corporations. Secondly, when a corporation distributes earnings to its shareholders through dividends, the distributions are subject to the income tax imposed upon individuals.

Because of the disparity between corporate tax rates and the higher graduated individual income tax rates,[4] a corporation can significantly reduce its shareholders' tax liability by accumulating its earnings beyond the amount reasonably needed to operate its business. Without some method to compel the distribution of unneeded corporate earnings, a controlling shareholder would be able to postpone the income taxes on his share of the earnings in excess of the corporate needs, or convert the income to capital gain through the sale

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[4] The corporate income tax rate is 22 percent of the first $25,000 of taxable income and 48 percent of the excess over $25,000. See Section 11 of the Internal Revenue Code of 1954. The graduated rates on individuals range from 14 percent to 70 percent. See Section 1 of the Code.

of his stock, or even escape income taxation entirely by retaining his interest for ultimate transfer at his death. See, generally, Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 8.01 (1971 ed.).

In order to foreclose the use of corporate entities as a means of avoiding the income tax on dividends received by shareholders, every revenue act since the adoption of the Sixteenth Amendment in 1913 has imposed a tax upon unnecessary accumulations of corporate earnings for the purpose of insulating shareholders from the income tax on dividends. As this Court explained in *Helvering* v. *Stock Yards Co.*, 318 U.S. 693, 699, and reaffirmed in *United States* v. *Donruss Co.*, 393 U.S. 297, 303, the purpose of the tax is "to compel the company to distribute any profits not needed for the conduct of its business so that, when so distributed, individual stockholders will become liable" for taxes on the dividends received.[5]

[5] As the Court pointed out in *United States* v. *Donruss Co.*, *supra*, 393 U.S. at 303–307, the accumulated earnings tax originated in Section IIA(2) of the Tariff Act of 1913, 38 Stat. 166, which imposed a tax on the shareholders of any corporation "formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed * * *." Accumulations beyond the reasonable needs of the business were "prima facie evidence of a fraudulent purpose to escape such tax * * *." The word "fraudulently" was deleted in the Revenue Act of 1918, Section 220, 40 Stat. 1072. It had made the provision "of little value, because it was necessary to its application that intended fraud on the revenue be established in each case." S. Rep. No. 617, 65th Cong., 3d Sess., p. 5.

The tax on the shareholders continued through 1920. Then, "[d]oubts apparently arose as to the validity of taxing income which the taxpayers had never received, and in 1921 it was thought safer to tax the company itself * * *." *United Business Corp.* v. *Commissioner*, 62 F.2d 754, 756 (C.A. 2). Thus, the framework of the present statute was adopted by Section 220 of the Revenue Act of 1921, 42 Stat. 247, which shifted the incidence of the tax from the shareholders to the corporation. The change was prompted by *Eisner* v. *Macomber*, 252 U.S. 189, which held that the distribution of common stock by a corporation having only common stock outstanding could not be taxed as income to the shareholders (see H. Rep. No. 350, 67th Cong., 1st Sess., pp. 12–13). However, the Court subsequently suggested that the 1921 change was an unnecessary precaution. See *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282, 288.

Although the statutory language has been changed from time to time, every income tax act since 1921 has imposed the tax on the corporation, rather than the shareholders. See Revenue Act of 1924, Section 220, 43 Stat. 277; Revenue Act of 1926, Section 220, 44 Stat. 34; Revenue Act of 1928, Section 104, 45 Stat. 814; Revenue Act of 1932, Section 104, 47 Stat. 195; Revenue Act of 1934, Section 102, 48 Stat. 702; Revenue Act of 1936, Section 102, 49 Stat. 1676; Revenue Act of 1938, Section 102, 52 Stat. 483; Internal Revenue Code of 1939, Section 102(a), (26 U.S.C., 1952 ed.).

The present statutory provsions, Sections 531 through 537, comprise Part I of Subchapter G of the Internal Revenue Code of 1954, a group of sanctions aimed generally at "Corporations Used to Avoid Income Tax on Shareholders." Section 531 imposes a tax in "addition to other taxes imposed by this chapter * * * on the accumulated taxable income * * * of every corporation" that is (Section 532(a)) "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders * * * by permitting earnings and profits to accumulate instead of being divided or distributed." Section 533(a) provides a rebuttable presumption that a corporation

which has accumulated earnings "beyond the reasonable needs of the business" did so with 'the purpose to avoid the income tax with respect to shareholders * * *." The fact of the accumulation is "determinative" of the tax avoidance motive "unless the corporation by the preponderance of the evidence shall prove to the contrary."[6]

Finally, Section 535(a) defines the base of the tax—"accumulated taxable income"—as the corporation's "taxable income" for the year at issue after adjustment for: (1) various items set forth in Section 535 (b); (2) the deduction in Section 561 for dividends paid; and (3) the accumulated earnings credit of Section 535(c). The adjustments prescribed in Section 535(a) and (b) are generally designed to insure that a corporation's "accumulated taxable income" more accurately reflects the amount actually available to the corporation for business purposes.

Thus, for example, in computing "accumulated taxable income", Section 535(a) provides a deduction for dividends paid (see Section 561), and Section 535(b)(1) permits an offset for federal income taxes—both of which are not deductible for ordinary income tax purposes.

[6] The present language of the statutory presumption originates in Section 102(c) of the Revenue Act of 1938, 52 Stat. 483. The legislative purposes was to replace the "prima facie" presumption with a "determinative" one to combat tax avoidance that had persisted "to a considerable extent" under pre-1938 law. See S. Rep. No. 1567, 75th Cong., 3d Sess., 4. By making the presumption "determinative", Congress shifted to the taxpayer not only the burden of going forward, as under prior law, but also the burden of proof, see *id.* at 16. See also, *United States* v. *Donruss Co.*, *supra*, 393 U.S. at 305–306.

Those payments deplete available corporate resources and must be deducted if an accurate picture of a corporation's economic condition is to be obtained. Conversely, Section 535(b)(3) disallows the dividends-received-deduction available to corporations for income tax purposes (see Section 243), since dividends received by a corporation would be freely available for use in its business.

This case focuses upon the extent to which a corporation's true economic condition becomes relevant in determining its liability for the tax upon "accumulated taxable income" imposed by Section 531 of the Code. Here, petitioner owned marketable securities, acquired at a cost of $154,222, which dramatically increased in fair market value to $1,634,592 and $2,551,210, as of the ends of its two taxable years at issue. However, it was stipulated that petitioner's reasonable business needs for those years were only $1,198,309 and $1,455,222. Because the marketable securities represented liquid assets freely available for use in petitioner's business, the Commissioner took their net realizable fair market value into account as a measure of petitioner's true financial condition in determining whether it had accumulated earnings "beyond the reasonable needs of the business" within the meaning of Section 533(a).

The question in this case is whether marketable securities owned by a corporation should be taken into account, as the decision below held, at their net realizable fair market value, or, as petitioner contends, at cost, for purposes of determining the availability of

working capital for the reasonable needs of the business.[7] We submit that the decision of the court of appeals upholding the Commissioner's measure of petitioner's marketable securities at their net realizable fair market value is grounded on the economic reality which is at the heart of the congressional purpose underlying the tax on accumulated corporate earnings, as this Court stated—"to compel the company to distribute any profits not needed for the conduct of its business"—in order that the stockholders will bear the tax upon the dividends received. *Helvering* v. *Stock Yards Co., supra,* 318 U.S. at 699.

B. THE STATUTORY PURPOSE OF COMPELLING DISTRIBUTION OF PROFITS NOT NEEDED FOR THE CONDUCT OF THE BUSINESS REQUIRES THAT MARKETABLE SECURITIES BE TAKEN INTO ACCOUNT AT THEIR NET REALIZABLE FAIR MARKET VALUE IN DETERMINING WHETHER AN UNREASONABLE ACCUMULATION EXISTS

1. The target of the accumulated earnings tax is described in the final words of Section 532(a)—avoidance of the income tax with respect to shareholders "by permitting earnings and profits to accumulate instead of being divided or distributed." The tax is specifically designed to deter conduct—"the manipulation of dividends to avoid taxes" by avoiding a declaration of dividends "until a season more propitious for distribution." *United Business Corp.* v. *Commissioner,* 62 F. 2d 754, 755, 756 (C.A. 2). By imposing an additional tax when a corporation has accumulated earnings in excess of the "reasonable needs of the business," the statute provides a mechanism to compel the distribution of "profits not needed for the conduct of its business" (318 U.S. at 699).

[7] Petitioner does not contend that its marketable securities should not be considered as part of its liquid assets. Indeed, Treasury Regulations, Sections 1.533–1(a)(2)(ii) and 1.537–2(c)(4) provide that the presence of marketable securities is affirmative evidence of the tax-avoidance purpose. See *Cheyenne Newspapers, Inc.* v. *Commissioner,* 494 F. 2d 429, 435 (C.A. 10).

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As we shall point out in greater detail, *infra,* in urging that the correct measure of petitioner's marketable securities is their net realization value, we do not contend that the unrealized appreciation of petitioner's securities is "accumulated" "earnings and profits" within the meaning of Section 533(a). Rather, we submit that petitioner's ownership of the securities which are freely available for use in its business rendered unreasonable its failure to distribute to its shareholders its additional earnings for the years at issue for purposes of the tax on accumulated earnings. Pursuant to Section 535(a), it is those earnings, included in "accumulated taxable income", upon which the tax is imposed.

The ultimate fact that brings the accumulated earnings tax into play is the subjective tax-avoidance motive of those in command of corporate affairs. Corporate managers are hardly likely to acknowledge that the purpose of an accumulation was to avoid the tax on dividends with respect to the shareholders. As this Court observed in *United States* v. *Donruss Co., supra,* 393 U.S. at 307, "Congress recognized the tremendous difficulty of ascertaining the purpose of corporate accumulations" and "saw that accumulation was often necessary for legitimate and reasonable business purposes." In reviewing the legislative

history of the accumulated earnings tax, the Court there concluded that "[i]t appears clear to us that the congressional response to these facts has been to emphasize unreasonable accumulation as the most significant factor in the incidence of the tax" (*ibid.*). Thus, the existence of the tax-avoidance motive is demonstrated on the basis of the objective fact of the accumulation itself.

These considerations explain the need for the presumption in Section 533(a), which makes an unreasonable accumulation "determinative" on the issue of tax-avoidance purpose in the absence of a contrary showing. As Judge Learned Hand explained in holding the 1921 accumulated earnings tax valid, "a statute which stands on the footing of the participants' state of mind may need the support of presumption, indeed be practically unenforceable without it * * *." *United Business Corp.* v. *Commissioner, supra,* 62 F.2d at 755. The idea is to "make the taxpayer show his hand"—"to compel the taxpayer to disclose the facts" (*id.* at 755, 756). Thus, by focusing upon the reasonableness of the accumulation, Section 533(a) introduced into accumulated earnings tax determinations what this Court characterized in *Donruss Co.* as a "much more objective inquiry * * * susceptible of more effective scrutiny, than * * * the vagaries of corporate motive" (393 U.S. at 307).

The objective inquiry required by Section 533(a) involves an initial comparison of the corporation's "accumulated" "earnings and profits" with "the reasonable needs of the business."[8] However, since the purpose of the accumulated earnings tax is to compel the distribution of unneeded profits as dividends, a purely mechanical comparison of the total retained earnings of prior years with the reasonable needs of the business would not provide an accurate measure of the corporation's dividend-paying capacity.

In many situations, a corporation's accumulated earnings and profits on the liabilities side of the balance sheet is reflected in a variety of fixed assets such as plant and equipment on the assets side of the balance sheet. Investment in such fixed assets does not decrease the accumulated earnings and profits. That account represents the corporation's liability to its shareholders resulting from increases in its assets accounts attributable to profitable operations. But unlike cash or other liquid assets, earnings and profits cannot be spent.

Thus, even though a corporation's accumulated earnings and profits mathematically exceeded its reasonable business needs, it would be unrealistic and contrary to the underlying policy of the accumulated

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[8] Section 537(a)(1), added to the statute in 1954, defines the term "reasonable needs of the business" to include the "reasonably anticipated needs of the business." See S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 317–318. In addition, Section 906(a) of the Tax Reform Act of 1969, 83 Stat. 714–715, adding Sections 537(a)(2) and (3) for taxable years ending after May 26, 1969, expands the term "reasonable needs of the business" to include (1) the amount needed by a corporation to redeem stock of a decedent under Section 303 of the Code, and (2) in particular circumstances, the amount needed to redeem, from a private foundation, stock constituting excess business holdings.

earnings tax to assume that a corporation which had all of its accumulated earnings and profits invested in fixed assets used in the conduct of its business, could distribute any unneeded profits to its shareholders. A corporation's ability to pay dividends is a function of its liquidity, *i.e.*, the amount of idle current assets at its disposal.

As a result, it is settled that the determination whether a corporation has permitted earnings and profits to accumulate beyond the reasonable needs of its business requires an examination of the extent to which its liquid assets exceed its reasonably anticipated business needs. In *United Block Co.* v. *Helvering*, 123 F.2d 704, 705 (C.A. 2), Judge Learned Hand observed: "The really important question is, not how much capital of all sorts, but how much quick assets, it was reasonable to keep on hand for the business * * *." Accord: *Smoot Sand & Gravel Corp.* v. *Commissioner*, 274 F.2d 495, 501 (C.A. 4), certiorari denied, 362 U.S. 976; *Electric Regulator Corp.* v. *Commissioner*, 336 F.2d 339, 344 (C.A. 2); *Novelart Manufacturing Co.* v. *Commissioner*, 52 T.C. 794, 806, affirmed, 434 F.2d 1011 (C.A. 6), certiorari denied, 403 U.S., 918. See also Study Prepared for the Joint Committee on the Economic Report, *The Taxation of Corporate Surplus Accumulations*, 82d Cong., 2d Sess., pp. 11, 16–19.

Once it is recognized that the application of the accumulated earnings tax turns on whether the corporation has liquid assets in excess of its reasonable business needs, it follows that such assets must be taken into account at their net realizable fair market value. When such liquid assets are marketable securities, as in this case, their proper measure is their then realizable value, since it is that amount that controls the corporation's liquidity.

In comparing liquid assets with reasonable business needs, it makes little sense to use cost figures ($154,222) on the assets side of the equation which may bear no relationship to present value while using current economic data to determine the amount necessary for the reasonable needs of the business ($1,198,309 and $1,455,222).

The cost of those securities is an irrelevant gauge to petitioner's true financial condition. A potential lender appraising petitioner's financial condition would not evaluate petitioner's marketable securities at cost. For purposes of the accumulated earnings tax, the Commissioner similarly must consider the range of the current values of marketable securities since the nature of his inquiry is precisely the same as that of a potential lender, *i.e.*, what is the realistic financial condition of the corporation.

If assets are available for use in the business and they are "current" assets, *i.e.*, readily convertible into cash, their practical utility to petitioner can be measured only by the amount of cash realizable upon their sale, which far exceeded petitioner's business needs. Thus, petitioner could not justifiably fail to distribute its current earnings during the taxable years as dividends to its shareholders. Since the marketable securities in this case were readily convertible to cash, the symmetry of the statutory comparision of liquid assets with reasonable business needs required that the securities be measured at their net realizable cash value.[9]

2. In holding that petitioner's marketable securities had to be taken into account at their net realizable fair market value, the court of appeals correctly rec-

[9] Petitioner complains (Br. 17, n. 9) that the 5 percent Georgia income tax has not been taken into account in computing the net realized value of its marketable securities. However, that omission is due to the fact that the stipulation agreed to by petitioner provided that the cost of sale would have been a maximum of 25 percent of the gain (payable as federal capital gains taxes) and 6 percent of the fair market value (payable as brokerage commissions) (A. 55). See n. 1, *supra*. But even taking the Georgia tax into account, petitioner has not shown that the net realizable value would have been equal to or less than its business need. Of coure, petitioner's further assertions (Br. 17, n. 9) of the post-1969 tax consequences of such a sale are irrelevant. The pertinent time for measurement of the net realizable value is during petitioner's taxable years ended June 30, 1965 and 1966, the taxable years at issue. Petitioner's claims (Br. 18) concerning the decline in value of Xerox stock during the period June–September, 1974, are similarly irrelevant.

ognized (A. 133–134) that this Court's decision in *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282, rendered almost 40 years ago, had essentially resolved the question presented in this case. There, the Court held that unrealized losses in the value of marketable securities owned by a corporation was "evidence to be considered * * * in determining the issue of fact whether the accumulation of profits was in excess of the reasonable needs of the business" (304 U.S. at 291). Since the taxpayer in that case had massive accumulations of earnings from prior years, the Court went on to conclude that depreciation in the market value of the securities did not preclude a finding that the accumulation of the current year's profits was in excess of the reasonable needs of the business.

The teaching of *Nat. Grocery Co.* is fully applicable to the converse situation presented in this case. Here, petitioner's liquid assets have appreciated in value rather than depreciated. But in order to determine whether petitioner's available financial resources exceeded its reasonable and reasonably anticipated business needs, the court of appeals correctly concluded that the fair market value of petitioner's marketable securities represented a far more accurate measure of its available resources than their historical cost.[10] In

[10] Although petitioner acknowledges (Br. 13, 14) that the Court in *Nat. Grocery Co.* stated that depreciation in the market value of securities was "evidence to be considered", it argues (Br. 14) that the Court's use of cost figures for the securities in its opinion demonstrates that it concluded that such depreciation could not be taken into account in determining the existence of accumulated earnings and profits. A careful reading of the relevant portions of the opinion (304 U.S. at 291–

addition to the decision below, the *Nat. Grocery Co.* rule has been applied by several lower courts in taking into account the market value of appreciated securities for purposes of the accumulated earnings tax. See *Battlestein Investment Co.* v. *United States,* 442 F.2d 87, 89 (C.A. 5); *Henry Van Kumell, Inc.* v. *Commissioner,* 23 T.C.M. 1765, affirmed, 364 F.2d 746 (C.A. 10); *Golconda Mining Corp.* v. *Commissioner,* 58 T.C. 139, supplemental opinion, 58 T.C. 736, 737–739, reversed on other grounds, 507 F.2d 594 (C.A. 9). Contra, *Harry A. Koch Co.* v. *Vinal,* 228 F. Supp. 782 (D. Neb.).[11]

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292) indicates that the Court employed the cost figures to show that the taxpayer had permitted its prior earnings to accumulate by investing substantial amounts in securities which were unrelated to its business. While the Court held that the unrealized losses did not as a matter of law prevent the imposition of the tax on the current year's accumulated taxable income, it did so only after concluding that the taxpayer's cash position did not justify the retention of any further earnings.

Thus, *Nat. Grocery* does not stand for the proposition, urged by petitioner (Br. 14–15), that the cost of marketable securities is the relevant measure for purposes of the accumulated earnings tax. Indeed, the dramatic twenty-fold increase in the value of petitioner's marketable securities decisively refutes its argument that an increase in value is only "substantial evidence" that the full amount of the original investment is available to meet its business needs. Petitioner can hardly deny that the entire net amount realized from the sale of such securities would be available for use in its business.

[11] In *Harry A. Koch Co.*, relied on by petitioner (Br. 19, n. 10), the district court acknowledged the applicability of *Nat. Grocery Co.* to depreciated marketable securities but valued appreciated securities at cost. It based its decision on the fact that in light of the capital gains tax, it was unrealistic to as-

None of the reasons set forth in *American Trading & Production Corp.* v. *United States,* 362 F. Supp. 801 (D. Md.), affirmed *per curiam* on the opinion of the district court, 474 F.2d 1341 (C.A. 4)—the principal authority relied upon by petitioner (Br. 12–13)—establishes that the proper measure of marketable securities for purposes of the accumulated earnings tax is their cost. There, a corporation whose accumulated earnings were approximately $10,000,000

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sume that the full value of the securities would be available upon sale, and that accountants have traditionally valued such assets at cost on the balance sheet (228 F. Supp. at 784). Given the fact that the values employed by the Commissioner here were net realizable amounts after deduction for the capital gains tax and brokerage commissions, the district court's first objection is without force here.

Moreover, accounting conventions which are grounded upon the policy of representing a corporation's financial condition as conservatively as possible in order to protect investors and creditors, have no application to the question under the accumulated earnings tax whether a corporation has liquid assets in excess of its reasonable business needs. See *Golconda Mining Corp.* v. *Commissioner, supra,* 58 T.C. at 737. Under similar circumstances, this Court has consistently applied the congressional policy underlying a revenue statute even when it conflicts with standard accounting practice. See, *e.g., Schlude* v. *Commissioner,* 372 U.S. 128; *American Automobile Association* v. *United States,* 367 U.S. 687. At all events, it is becoming common practice to reflect both the fair market value and the cost of marketable securities on corporate balance sheets, even in the accounting profession. See Arthur Anderson & Co., *Accounting and Reporting Problems of the Accounting Profession* (1962 ed.), p. 110, *et seq.*, reprinted in Fiflis & Kripke, *Accounting for Business Lawyers* (1971 ed.), pp. 125–126; Kester, *Advanced Accounting*, pp. 117–118 122–124 (1946 ed.). Indeed, petitioner itself reflected the fair market value as well as the cost of its marketable securities on its corporate balance sheets for the taxable years at issue (A. 112, 118).

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and whose anticipated business needs totaled approximately $12,000,000 was held not to be liable for the accumulated earnings tax despite the fact that it owned marketable securities that had "explosively increased in value" from an original cost of $5,593,319 to a current market value in excess of $100 million (362 F. Supp. at 806–807, 808–809, 811). The district court excluded those securities from consideration in determining whether the corporation had permitted earnings to accumulate in excess of its reasonable business needs on three grounds: (1) that the appreciated securities constituted the corporation's original capital; (2) that the accumulated earnings tax statute was not intended to require the conversion of such assets to cash to meet business needs; and (3) that the securities laws might have created some impediment to marketability. The court of appeals affirmed *per curiam*.

To the extent *American Trading* rests upon the fact that the taxpayer's marketable securities were part of its original capital, the decision is erroneous. We agree with petitioner (Pet. 8) that "this factor has no independent significance." Appreciated liquid assets must be valued at realizable fair market value whether or not they are part of a corporation's original capital since they are at all events available to meet the reasonable needs of the business.[12] The sec-

[12] The irrelevance of original capital is further demonstrated by Section 533(b), which provides that the fact that any corporation is a mere holding or investment company shall be *prima facie* evidence of the purpose to avoid the income tax with respect to shareholders. Suppose a corporation engages in no business activity other than to hold appreciated marketable securities and they constitute its original capital and the corporation em-

ond ground is equally erroneous. The statute requires an examination of all of a corporation's assets which are freely available to meet business needs and necessarily assumes that all of such assets could be converted to cash for use in the buiness. However, given the court's finding that the securities "were not available as readily liquid assets" as a result of restrictions imposed by the securities laws (362 F. Supp. at 809, 824), the case can be read to stand for the proposition that non-liquid assets are not available to meet the needs of the business. Where, as here, petitioner's securities were unquestionably marketable and liquid in character, the third ground of *American Trading* has no application.[13]

3. a. Faced with the economic reality that its net liquid financial condition did not justify accumulation of any of its taxable income during the years at issue, petitioner is forced to argue (Br. 9–12) that Section 533(a) is limited to a comparison of a corporation's "earnings and profits" with its reasonable business needs. Since the unrealized appreciation of marketable securities are not included in a corporation's earnings and profits (see Treasury Regulations, Section

ploys securities analysts and clerical personnel. Under these circumstances, exclusion of the marketable securities from consideration in determining whether it has permitted its earnings to accumulate beyond its reasonable business needs would effectively undermine the mandate of Section 533(b).

[13] The fact that the court in *American Trading* excluded the marketable securities altogether—rather than just the amount of their increase in value—shows that it viewed them as non-liquid assets. Thus, the case is not authority for petitioner's argument that only the cost of marketable securities should be considered in determining whether a corporation has permitted its earnings to accumulate beyond the reasonable needs of the business.

1.312–6(b)), petitioner contends that such appreciation should not be taken into account for purposes of the accumulated earnings tax. Since petitioner claims to have purchased its marketable securities with earnings, it argues that the cost of such assets is the proper measure.[14]

Petitioner's argument focuses upon the irrelevant fact that the unrealized appreciation of its marketable securities is not part of its "earnings and profits". We do not contend to the contrary. The question in every accumulated earnings tax case is whether the corporation can justifiably retain its current taxable income rather than distribute it as dividends. It is that income, adjusted to constitute "accumulated taxable income" in Section 535(a), upon which the tax is imposed.

Thus, contrary to petitioner's argument, the Commissioner has not determined that it has accumulated non-existent earnings. To the contrary, the Commissioner has determined that it has freely available assets in excess of the reasonable needs of its business so that its accumulation of its taxable income for the years at issue is unreasonable. The utility of such

[14] Petitioner also argues (Br. 11–12) that its position is buttressed by the fact that neither Section 533(a) nor the Regulations refer to unrealized appreciation. The same may be said of unrealized depreciation which this Court held in *Nat. Grocery Co.* was "evidence to be considered" and the liquid assets test which has been universally applied. Both of these analyses go to an examination of whether a corporation has freely available assets in excess of its reasonable business needs, the critical question under the accumulated earnings tax.

assets in petitioner's business can only be accurately measured at their net realizable value.

The error of petitioner's argument is illustrated by the following example. Suppose a corporation has no prior accumulated earnings and profits which are freely available for use in its business. However, it has earnings and profits for the current year of $1,000,000 and reasonable business needs of $1,000,000. Under those circumstances, the corporation would not be subject to the tax in the absence of any distributions to shareholders.

Suppose further, that one of the shareholders makes a capital contribution of $1,000,000 in cash, which cannot be related to any reasonable business need or to any reasonably anticipated business need. Plainly, the capital contribution is not includable in the corporation's taxable income or in its earnings and profits. See Section 118(a) of the Code. However, the availability of the extra $1,000,000 of cash subjects the accumulated taxable income of the year to the tax since there is no longer any justifiable reason for its retention. The fact that the $1,000,000 capital contribution is not included in the corporation's earnings and profits does not foreclose its consideration in determining whether the corporation is subject to the tax on accumulated earnings.

b. Moreover, petitioner's emphasis upon "earnings and profits" ignores the well-settled liquidity test. As we have pointed out, *supra,* pp. 19–20, 24, the courts have not read Section 533(a) as requiring a rigid mathematical comparison of the corporation's earnings and profits with its reasonable business needs. As

it must, petitioner acknowledges (Br. 10) the correctness of decisions such as *Smoot Sand & Gravel Corp.* v. *Commissioner*, 274 F.2d 495 (C.A. 4), certiorari denied, 363 U.S. 976. Those cases have held that the proper question is whether the corporation has freely available liquid assets in excess of its expected reasonable needs and not whether its *total* accumulated earnings and profits (which may be represented by plant, equipment and inventory) exceeds its reasonable business needs. Indeed, if the rule were otherwise, and petitioner's total earnings and profits were compared to its stipulated reasonable business needs, it is beyond question that the statutory presumption of the tax-avoidance purpose would be operative.[15]

Petitioner cannot have it both ways. If Section 533(a) requires a consideration of its "earnings and profits", then its total earnings and profits must be measured against its reasonable business needs. However, petitioner cannot merge the liquid assets test with the long-rejected "earnings and profits" test and create a hybrid formula which limits consideration of liquid assets to their cost as the measure of accumulated earnings and profits.

The liquid assets test and the accumulated earnings and profits test operate on entirely contrary assumptions and cannot be so combined. The essence of the liquid assets test is a realistic determination of the resources of a corporation available to meet its reasonable business needs. Thus, if, as petitioner concedes, the economic reality of the liquid assets test is the governing standard, an accurate appraisal of its unneeded liquid assets can be achieved only if its marketable securities are taken into account at their net realizable value.[16]

Contrary to petitioner's further argument (Br. 15–16, 19–20), nothing in *Eisner* v. *Macomber*, 252 U.S. 189, prohibits the annual measure of its marketable securities at their net realizable fair maket value for purposes of determining its liability for the accumulated earnings tax. There, the Court held that a common stock dividend issued by a corporation having only common stock outstanding was not includable in gross income for income tax purposes because there was no "realization" of profits by the stockholder.

As we have pointed out, this case does not involve a tax upon unrealized appreciation of petitioner's marketable securities. To the contrary, that appreciation is simply considered in order to determine whether petitioner has net liquid assets in excess of its reasonable business needs. Once it is determined that a corporation has passed the threshold of permissible accumulations, the tax is presumptively triggered. Pursuant to Section 535(a), the tax is imposed on the "accumulated taxable income" for the years at

[15] Petitioner's earnings and profits as of June 30, 1965 and 1966 were $2,200,184.77 and $2,360,146.52 (A. 70, 91). To the latter amount must be added $262,822.75, an amount attributable to a 10 percent stock dividend which petitioner subtracted from retained earnings and allocated to capital surplus (A. 91). However, a stock dividend does not reduce earnings and profits for tax purposes. See Treasury Regulations, Section 1.312-1(d). As of those dates, petitioner's reasonable business needs were $1,198,309 and $1,455,222 (A. 56).

[16] Indeed, had petitioner distributed the amount of its "accumulated taxable income" to its shareholders as dividends, it would have totally avoided the imposition of the tax. See Sections 535(a) and 561.

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issue which petitioner could not justifiably retain in light of its highly liquid position. Thus, the tax base does not include the unrealized appreciation of the marketable securities.

4. Finally, petitioner urges (Br. 16) that the effect of the decision below "is to force [it] and all other corporations similarly situated to convert their appreciated assets in order to meet their business needs * * *." In its view (Br. 17), "corporate management should be entitled, in the exercise of its business judgment, to finance business needs solely out of earnings and profits without resorting to unrealized appreciation through a forced liquidation of corporate assets and without fear of being subjected to the accumulated earnings tax."

Such broad rhetoric goes far beyond the scope of petitioner's argument. To be sure, if petitioner's marketable securities were excluded from consideration, it would never have to convert them to cash. But even petitioner does not urge such total exclusion.

Even if marketable securities were taken into account at cost, as petitioner argues, situations could arise where the corporation might have to convert such an investment into cash to meet its reasonable business needs if it wished to avoid imposition of the accumulated earnings tax. Thus, whether marketable securities are taken into account at cost or at net realizable value, the conversion of such securities into cash is equally required if the tax is to be avoided.[17] The propriety of the net realizable value

[17] For example, suppose a corporation has $1,000,000 of prior earnings with which it purchases marketable securities unrelated to its business, which are now worth $1,500,000. In the current year, the corporation's current earnings are $600,000 and its reasonable business needs are $1,300,000. If the cost method of valuation were used, the corporation would have "accumulated taxable income" of $300,000 ($600,000−$1,300,000+$1,000,000) and be required to distribute that amount or bear an accumulated earnings tax on $300,000. Absent any other assets, and ignoring expenses of sale, a $300,000 distribution would require conversion of a portion of the marketable securities. If the fair market value were used, the corporation's liquid assets ($1,500,000) would exceed its reasonable business needs ($1,300,000) so that no part of the current year's income could be reasonably retained. It would be required to distribute the entire $600,000 of current earnings and also to convert securities. Thus, under both methods, the corporation would have to convert part of its marketable securities to cash.

rule for the marketable securities, which we urge here, is that it unquestionably reflects the liquidity, and relates to the reasonable business needs, of the corporation more accurately than the cost of such assets.

The decision of the court of appeals in this case does not, as petitioner argues, unduly interfere with corporate management's business judgment. Of course, the accumulated earnings tax itself shapes management judgment, and is intended to do so. As a leading text has stated, the tax "involves a hindsight verdict on management's business judgment." Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* (1971 ed.), par. 8.01, p. 8–4. Thus, petitioner's objections are essentially directed at the validity of the accumulated earnings tax which it does not challenge and which this Court upheld almost 40 years ago in *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282.

By requiring the corporation to prove by a preponderance of the evidence that accumulations beyond

the reasonable needs of the business were not motivated by tax avoidance (Section 533(a)), Congress established a system under which a corporation must justify its failure to distribute current earnings as dividends. From the corporation's point of view, the imposition of the tax and the statutory presumption may indeed appear to be "an impediment to legitimate business decisions" (Br. 16). But the statutory presumption which operates upon the objective finding of a corporate accumulation beyond the reasonable business needs is necessary if the congressional policy of compelling the distribution of unneeded profits is to be enforced. That policy, we submit, is best served by measuring the corporation's liquid assets at their realistic net realizable value.

CONCLUSION

For the reasons stated, the judgment of the court of appeals should be affirmed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 531. Imposition of Accumulated Earnings Tax.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

SEC. 532. Corporations Subject To Accumulated Earnings Tax.

(a) *General rule.*—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * * * *

SEC. 533. Evidence of Purpose To Avoid Income Tax.

(a) *Unreasonable accumulation determinative of purpose.*—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to

avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

* * * . * *

SEC. 535. Accumulated Taxable Income.

(a) *Definition.*—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

(b) *Adjustments to taxable income.*—For purposes of subsection (a), taxable income shall be adjusted as follows:

(1) Taxes.—There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits tax imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits, and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 275(a)(4)), accrued during the taxable year or deemed to be paid by a domestic corporation under section 902(a)(1) or 960(a)(1)(C) for the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law.

(2) *Charitable contributions.*—The deduction for charitable contributions provided under section 170 shall be allowed without regard to section 170(b)(2).

(3) *Special deductions disallowed.*—The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) *Net operating loss.*—The net operating loss deduction provided in section 172 shall not be allowed.

(5) *Capital losses.*—There shall be allowed as deductions losses from sales or exchanges of capital assets during the taxable year which are disallowed as deductions under section 1211(a).

(6) *Long-term capital gains.*—There shall be allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined without regard to the capital loss carryback or carryover provided in section 1212) minus the taxes imposed by this subtitle attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between: (A) the taxes imposed by this subtitle (except the tax imposed by this part) for such year, and (B) such taxes computed for such year without including in taxable income the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined with regard to the capital loss carryback and carryover provided in section 1212).

(7) *Capital loss.*—No allowance shall be made for the capital loss carryback or carryover provided in section 1212.

(8) *Bank affiliates.*—There shall be allowed the deduction described in section 601 (relating to bank affiliates).

(9) *Distributions of divested stock.*—There shall be allowed as a deduction the amount of any dividend distribution received of divested stock (as defined in subsection (e) of section 1111), minus the taxes imposed by this subtitle attributable to such receipt, but only if the stock with respect to which the distribution is

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made was owned by the distributee on September 6, 1961, or was owned by the distributee for at least 2 years prior to the date on which the antitrust order (as defined in subsection (d) of section 1111) was entered.

(10) *Special adjustment on disposition of antitrust stock received as a dividend.*—If (A) a corporation received antitrust stock (as defined in section 301(f)) in a distribution to which section 301 applied, (B) the amount of the distribution determined under section 301 (f)(2) exceeded the basis of the stock determined under section 301(f)(3), and (C) paragraph (9) did not apply in respect of such distribution, then proper adjustment shall be made, under regulations prescribed by the Secretary or his delegate, if such stock (or other property the basis of which is determined by reference to the basis of such stock) is sold or exchanged.

(c) *Accumulated earnings credit—*

(1) *General rule.*—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b)(6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) *Minimum credit.*—The credit allowable under paragraph (1) shall in no case be less than the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

* * * * *

SEC. 537. Reasonable Needs of the Business.

(a) *General rule.*—For purposes of this part, the term "reasonable needs of the business" includes—

(1) the reasonably anticipated needs of the business

* * * * *

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